

State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2005



Proposed Changes to the School Bond Loan Fund and a Discussion of Jobs Today for Schools

By Kathryn Summers-Coty, Fiscal Analyst

Article IX, Section 16 of the Michigan Constitution of 1963 requires the State to make loans to school districts under certain conditions. Over the last four decades, the amount of loans the State has made to districts has grown, and now stands at more than \$704.0 million. Because the State must borrow in order to have money to lend, the State incurs debt service costs. These costs grow over time because the rate at which the districts repay the State is slower than the rate at which the State pays back its own debt. This differential in repayment rates causes a drain on the School Aid budget, which in fiscal year (FY) 2005-06 is scheduled to pay \$44.5 million in debt service costs for the School Bond Loan Fund (SBLF). The problem of escalating State debt service costs is one reason that the Administration of Governor Granholm has proposed changing the SBLF into a self-sustaining revolving fund. Other issues surrounding school bonding also are addressed in the proposed reform and are discussed below. At the end of the article is a discussion of the schools' portion of the Jobs Today package, which involves the issuance of bonds for school construction, renovation, or demolition.

School Construction in Michigan

When school districts need to issue bonds for construction purposes, they may use a process called "qualification". Qualified bonds are issued for a period of 10 to 30 years, and require qualification by the State Treasurer and approval of the district's voters. Qualification is based on an extensive preliminary review of the project by the Treasurer, including demonstration of project need, reasonable costs, and enrollment projections; projects built with qualified bonds must use prevailing wages and benefits.

If a district's bonds become "qualified", three items are accomplished: 1) The bonds are guaranteed by the State; 2) the district is able to use the State's credit rating when selling its qualified bonds, thereby obtaining a lower interest rate; and 3) if the district's millage levy in any given year is insufficient to pay the principal and interest, the district may borrow the difference from the SBLF.

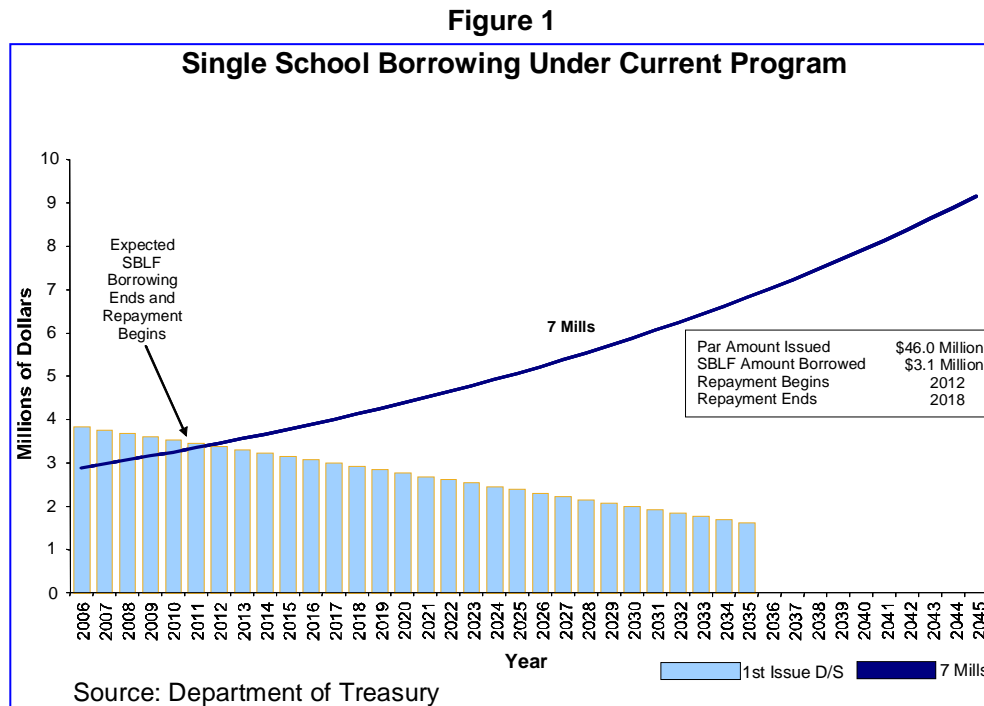
Districts do not need to seek State qualification for their bonds. Out of 553 school districts in the State, 422 districts have sought the qualification process for current bond issues. Most districts that use the qualification process do not borrow from the SBLF. In other words, their millage levies bring in enough revenue to meet the yearly principal and interest payments on their construction bonds. In fact, of the 425 districts that issued qualified bonds, only one-third (147) have borrowed (or are borrowing) from the SBLF and have current balances; as mentioned above, these balances total more than \$704.0 million. The other two-thirds of the districts, while not borrowing, still reap the benefit of the State's credit rating via the qualified status of bonds.

The School Bond Loan Fund

In order to borrow from the SBLF, a district first must have issued "qualified" bonds for its construction. Second, the district must levy at least seven mills to pay the interest and principal on those bonds. If the mills levied in any particular year do not generate enough revenue to pay the interest and principal on the qualified bonds, then the district may borrow from the State's SBLF the amount necessary to meet the debt service payment. The loan process continues until the revenue from a district's millage levy exceeds the principal and interest payment on the construction bonds.



At this point, the district uses the excess tax proceeds to begin repayment to the State until the outstanding SBLF balance has been paid. Repayment of SBLF loans must be completed within five years of the district's bonds' maturity date. This process is illustrated below in Figure 1.



Concerns with the Existing SBLF Program

As mentioned in the introduction, the State incurs debt service costs on the dollars it borrows in order to have money available to lend to school districts in the SBLF program. One would think that the repayments by school districts on money borrowed from the SBLF would be enough to cover the State's debt service costs, but this is not the case. Under current law, districts may postpone repayment of their SBLF debt by obtaining qualification and issuing new bonds on a second construction project *before* repaying the State for the first project's borrowing. This practice is illustrated in Figure 2. Therefore, the State repays its debt more rapidly than it receives payments from districts.

If no change is made to current law to require that districts pay off their current debt before borrowing subsequent times, the anticipated State debt service for the SBLF (currently paid for in the K-12 budget) will reach \$200.0 million in 2021, falling to a constant \$165.0 million annual cost (using current assumptions) beginning in 2026, as shown in Figure 3.

Other concerns with current bonding laws relate to information that districts must provide to voters when deciding a construction question. One of the Administration's goals in reforming the SBLF program is to improve the dialogue between districts and electors. Currently, electors are not made aware that a district may have to continue to levy debt mills after the bonds are paid off if money has been borrowed from the State. Also, electors are not, under current law, informed that the district incurs additional expenses for projects when the district borrows from the State.



Figure 2

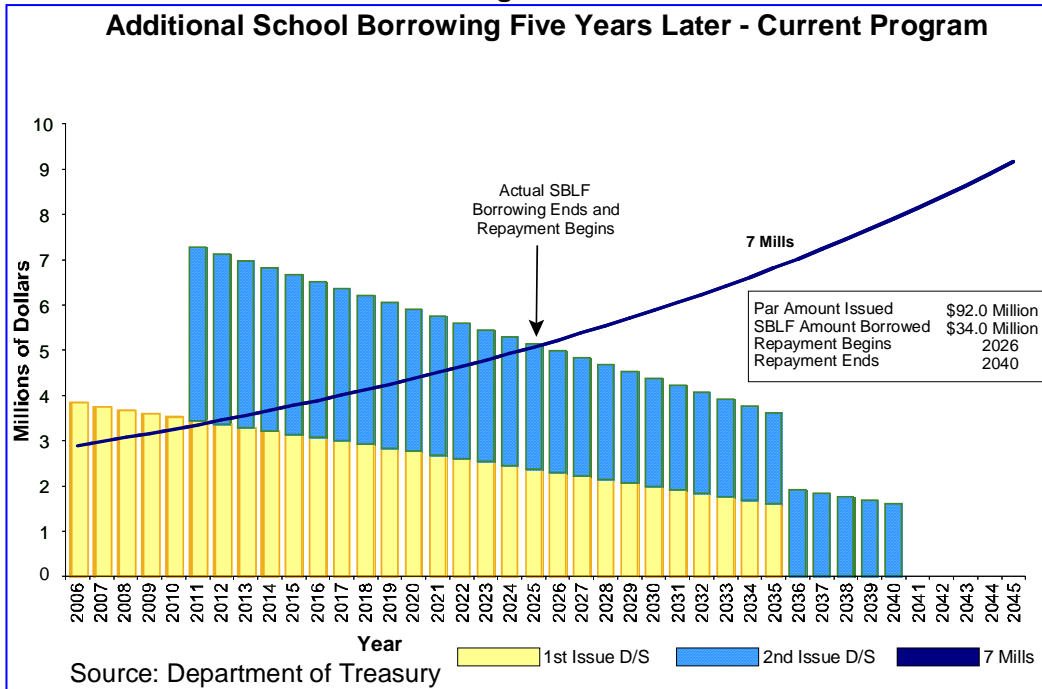
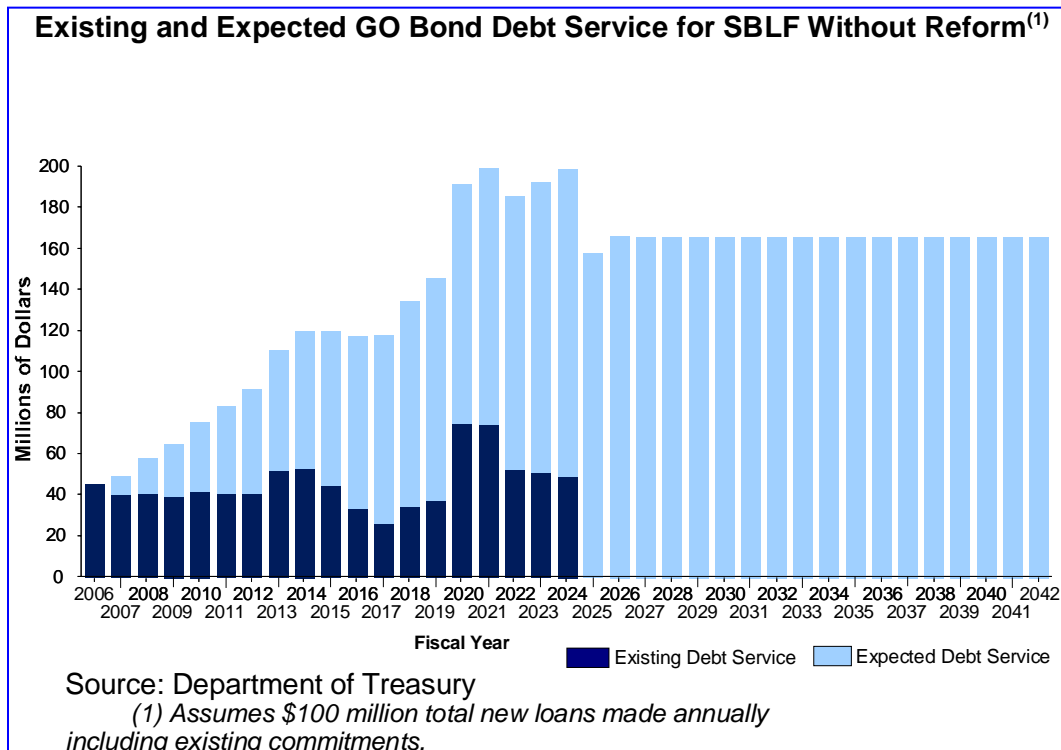


Figure 3



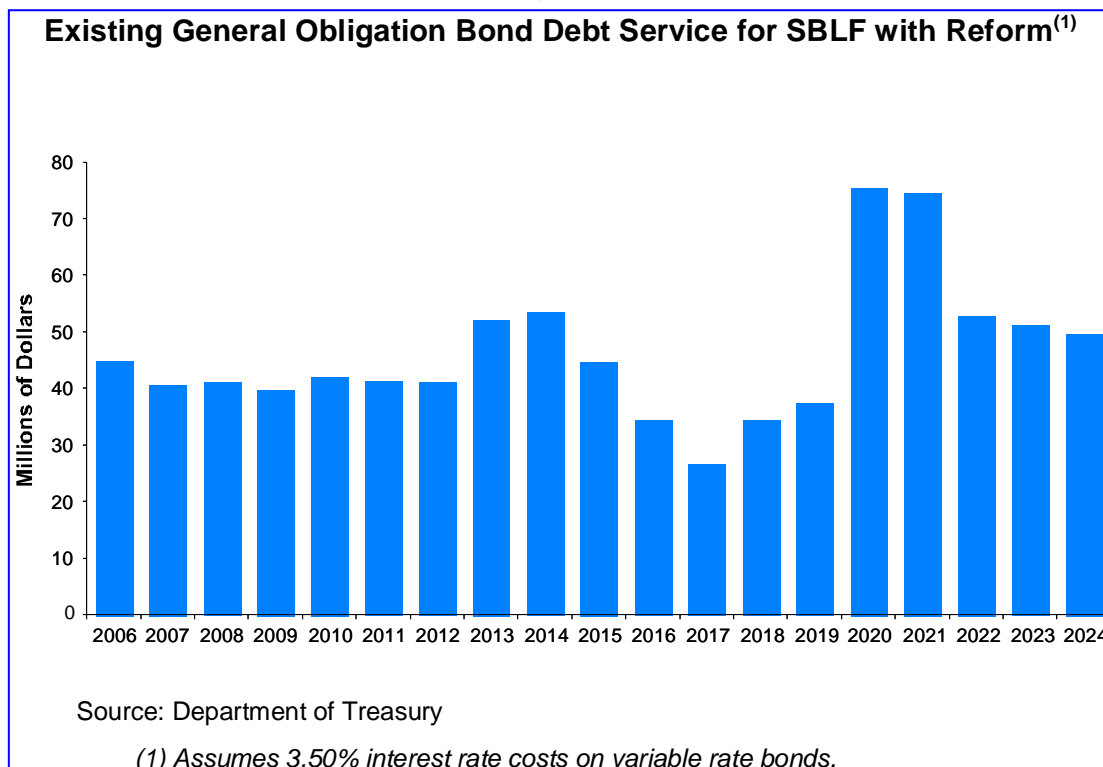


The Proposal – A Revolving Fund and More Voter Information

The Administration is proposing to transform the existing SBLF program into a school bond revolving loan fund. To accomplish this, districts would be required to pay off existing loans from the SBLF using a fixed repayment schedule before they would be able to borrow again. By requiring districts to repay current obligations with a fixed repayment schedule, the State could transform the existing SBLF from a liability into an asset since the State would receive a fixed, reliable income stream. The State then would borrow against that asset, generating an initial estimated \$435.5 million in proceeds. These proceeds would be used to deposit \$86.1 million into the School Aid Fund to cover debt service on the old SBLF program both in the current fiscal year, 2004-05, and in next year's budget. (This deposit is assumed to balance both the current year enacted K-12 budget and next year's K-12 budget proposal.) At least \$300.0 million would be used as the initial capitalization to begin the revolving loan fund. The remaining dollars would be used to cover costs associated with the transformation to a revolving fund, as well as the establishment of a debt service reserve fund.

The fixed repayments from districts on their existing debt under the old SBLF program would be used in two ways: 1) to pay the debt service on the funds provided through the capitalization to establish the new program, and 2) to make dollars available for loans under the new revolving fund. Repayments from districts on money borrowed in the new fund would be used to make new loans as well. In this manner, the revolving fund would be self sustaining and generally would no longer require the State to undertake more general obligation debt and incur more debt service costs. The only cost to the State in the future would be the remaining debt service on previous general obligation debt incurred under the old SBLF program, the cost of which would cease to exist in approximately 20 years. Figure 4 illustrates the declining debt service burden if reform is enacted.

Figure 4





Other proposed changes in the program involve requiring districts to provide more information to voters when holding elections for construction bonding. The Administration is proposing that districts be required to place language on the ballot informing voters that the districts may borrow from the SBLF and may have to continue to levy debt mills after the bonds have been repaid.

Jobs Today for Schools Proposal

Governor Granholm has proposed a Jobs Today initiative that envisions the creation of jobs through several types of investments. A component of this is the proposal that a total of \$500.0 million of qualified bonds be made available to districts for critical construction, renovation, or demolition of aging school buildings. Districts would be able to issue qualified bonds and not increase their current debt millage for at least the first five years. Districts would borrow the entire debt service payment on those bonds from the State for those first five years. The State would use resources in the newly created revolving fund to make the debt service loans to districts.

Districts that issued qualified bonds under the Jobs Today package would borrow debt service payments from the State and pay 0% interest on those State loans. School districts, except for those levying zero mills now, would not need to levy additional taxes to pay the debt service on their borrowing. The length of time for the levy, however, would be extended for the districts to pay back the bonds issued along with the 0% interest loans borrowed from the State. Those districts levying zero mills today would continue to levy zero mills for the first five years, and beginning in the sixth year would levy the lesser of the mills necessary to make the debt service payment on Jobs Today bonds, or two mills. Voters would need to approve a school district's issuance of bonds for the Jobs Today package. The one exception to this would be if a district chose to issue "budget" bonds for renovation or demolition under this package, and use operating funds (rather than debt millage) to pay the debt service and then repay the SBLF. "Budget" bonds require a notice to voters 45 days before the issuance of bonds, giving voters time to halt the issuance via referendum if so desired.

Under the Administration's proposal, the \$500.0 million of qualified bonds would be approved for school districts on the basis of the following (unranked) eight criteria:

- Readiness of the district to issue bonds, as measured by the completeness of design and planning;
- Age and condition of facilities to be renovated, replaced, or demolished;
- Taxable value per pupil;
- Severity of environmental or usability problems such as asbestos abatement, energy conservation, or Americans with Disabilities Act requirements;
- Technology needs;
- Age and condition of the facilities as a whole;
- Overall condition of facilities; and,
- Utilization of classrooms.

The \$500.0 million of qualified bonds would be available for two purposes: 1) \$320.0 million for renovation or demolition, and 2) \$180.0 million for the construction of small high schools. For a district to be eligible to apply for Jobs Today loans to construct one or more qualified small high schools, the district must meet the following criteria: 1) have at least 800 pupils in grades 9 to 12; 2) use the qualified small high school(s) to improve the graduation rate and/or improve achievement in English language arts or mathematics in order to achieve proficiency under the Federal No Child Left Behind Act; 3) adopt a proven model for curriculum and operational structure of the qualified small



high school(s); and, 4) adopt a resolution committing sufficient funds from private and public sources to pay for planning and startup operating costs of the new school(s).

Any district could apply for up to \$10.0 million for renovation purposes, \$10.0 million for demolition purposes, or \$15.0 million for the construction of small high schools, but no district would be approved for more than \$25.0 million in total qualified bonds under this program. An exception to this would be for districts with more than 20,000 pupils. In their cases, up to \$30.0 million would be available for the construction of small high schools, with no more than \$40.0 million approved in total qualified Jobs Today bonds. Also, if there were no flood of applicants during the first six months, the Department of Treasury is proposing that it be allowed to increase loans to existing applicants for all three purposes (renovation, demolition, and small high school construction).

Three years are planned by the State to approve the \$500.0 million in qualified bonds, with construction work on approved projects beginning before December 31, 2007. It is estimated by the Administration that this portion of the Jobs Today package would create approximately 8,000 jobs.

It is important to note that the SBLF reform discussed earlier can be a stand-alone project. The Jobs Today for Schools package does not need to be enacted in order to accomplish reform of the SBLF. However, if the Jobs Today for Schools package *is* enacted, in order to avoid General Fund debt service costs, either the revolving fund itself, must be created by reform of the existing SBLF program, or excess district repayments into the revolving fund must occur.

State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2005



Federal Expenditures in Michigan

By Gary S. Olson, Director

Each fiscal year, the Federal government allocates a significant portion of the overall Federal budget to expenditures that have a direct impact on the states. The United States Bureau of the Census annually reports on these Federal expenditures to the states in its report entitled, "*Consolidated Federal Funds Report*". The most recent Consolidated Federal Funds Report is for fiscal year (FY) 2003.

The Census Bureau report covers four broad categories of Federal expenditures received by states. These categories are: direct payments to individuals, Federal salaries and wages, procurement, and grants to state and local governments. Direct payments to individuals include such large Federal programs as Social Security, Federal retirement and disability payments, student loans, workers' compensation payments, and food stamps. Federal salaries and wages measure the amount spent on the base salary and overtime of Federal employees in each state. Procurement is the amount spent in each state for direct purchases by the Federal government of either goods or services. Grants to state and local governments are direct Federal aid programs and include such large programs as Federal transportation aid, job training aid, education spending, and the Medicaid program.

Historically, Michigan's share of Federal expenditures has lagged behind the amount of most other states. As measured on a per-capita basis, in FY 2003 total Federal expenditures in Michigan equaled \$5,741. The national average of all states on a per capita basis was \$6,941. Table 1 provides a summary of Federal expenditures in Michigan during FY 2003. Michigan's total per-capita expenditures ranked 44th among the states. The only broad category of Federal expenditures in which Michigan was close to the national average was the area of direct payments to individuals, where Michigan's share ranked 28th among the states. Michigan's rank in Federal salaries and wages was 49th among the states, Michigan's rank in procurement was 43rd among the states, and Michigan's rank in grants to state and local governments was 41st among the states.

Table 1
Distribution of Federal Funds
Fiscal Year 2003
(Millions of Dollars)

	National Amount	Michigan Amount	Michigan as Percent of National Total	National Per Capita	Michigan Per Capita	Michigan Rank
Direct Payments for Individuals	\$1,082,358	\$37,598	3.5%	\$3,691	\$3,730	28
Federal Salaries and Wages	210,677	3,418	1.6%	713	339	49
Procurement	327,413	3,884	1.2%	1,011	385	43
Grants to State and Local Governments	441,038	12,970	2.9%	1,496	1,287	41
Total	\$2,061,486	\$57,870	2.8%	\$6,911	\$5,741	44
Resident Population	290,809,777	10,079,985	3.5%			

Source: United States Bureau of the Census, Federal Expenditures by State for Fiscal Year.



An analysis of the Census Bureau data leads to the conclusion that the citizens of Michigan are receiving much less than their fair share of Federal expenditures if the expenditures were simply distributed on a per-capita basis. Table 2 provides a summary of the actual amount of Federal expenditures received in Michigan for the period FY 1985 through FY 2003 versus the amount that Michigan would have received if Federal expenditures had equaled Michigan's of the total United States population. In FY 2003, this Federal funding shortfall equaled \$13.6 billion.

Table 2
Michigan's Federal Funding Shortfall
(Millions of Dollars)

Fiscal Year	Actual Federal Expenditures in Michigan	Federal Expenditures in Michigan on a Per-Capita Basis	Michigan's Expenditures Shortfall
1985	\$22,384	\$29,844	\$(7,460.8)
1986	23,342	31,398	(8,055.5)
1987	23,283	31,814	(8,530.4)
1988	23,887	33,207	(9,320.3)
1989	26,109	34,735	(8,625.3)
1990	29,433	37,438	(8,005.6)
1991	31,968	41,292	(9,323.4)
1992	36,137	44,998	(8,860.3)
1993	37,238	46,845	(9,607.2)
1994	39,485	49,021	(9,536.4)
1995	39,569	49,055	(9,486.5)
1996	39,633	50,062	(10,429.2)
1997	40,651	51,441	(10,789.7)
1998	41,917	53,905	(11,988.6)
1999	44,128	55,355	(11,227.5)
2000	46,851	58,242	(11,390.9)
2001	51,722	62,986	(11,264.3)
2002	55,910	67,566	(11,656.2)
2003	57,870	71,455	(13,584.8)

Source: United States Bureau of the Census, Senate Fiscal Agency calculations.

This Federal funding shortfall in Michigan can be attributed to several factors. First is the fact that Michigan has a smaller proportion of Federal direct employees compared with other states. The second is the lack of major defense facilities or defense contractors within Michigan. The third major factor influencing the distribution of Federal funds is that numerous Federal funds have formulas that take into account income levels. This type of formula does not generally benefit Michigan compared with many other states. These factors and others account for the long-term distribution of Federal funds and affect the amount of Federal funds received in Michigan.

State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2005



Health Savings Accounts **By Julie Koval, Legislative Analyst**

Health care costs have risen dramatically over the last few years, limiting affordability and access for many people. Health care constitutes one of the largest costs for many businesses, particularly small ones, and employers are shifting an increasing share of the burden to workers or, in some cases, dropping coverage altogether. According to a Harvard University study published in the February 2005 issue of *Health Affairs*, more than half of all personal bankruptcies filed in the United States are due to medical expenses.

Some of those seeking to contain health care costs suggest that one part of the solution might be health savings accounts (HSAs). These accounts were authorized by Congress under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173). The Act applies to tax years beginning after December 31, 2003, and allows an individual to open a tax-exempt savings account specifically for “qualified medical expenses”, i.e., amounts paid by an account beneficiary for medical care for himself or herself, or his or her spouse or dependent, to the extent that such amounts are not compensated for by insurance or otherwise. The interest gained on money in the account also is exempt from taxation.

This article discusses the Federal legislation, and describes proposals that have been introduced in Michigan to allow tax credits or deductions for HSA contributions.

Eligibility

According to the Internal Revenue Service (IRS), in order to open an HSA, an individual must meet several criteria. First, he or she must be covered by a high-deductible health plan (HDHP). Under the Act, that term means a health plan with an annual deductible of at least \$1,000 for self-only coverage or \$2,000 for family coverage. Additionally, for 2005, the sum of the annual deductible and the other annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered benefits may not exceed \$5,100 for self-only coverage or \$10,200 for family coverage. (The Act requires that these amounts be adjusted annually to reflect a cost-of-living increase.)

Second, an individual may have no other health coverage except for insurance that covers workers' compensation, tort, or property ownership or use liabilities, or coverage for accidents, disability, dental care, vision care, and long-term care. Third, an individual may not be eligible for Medicare. Finally, an individual may not be able to be claimed as a dependent on someone else's tax return.

HSA Contributions

An individual may make contributions to an HSA tax-free subject to certain limitations established in statute, which annually must be adjusted based on the increase in the cost of living. For 2005, the monthly limitation for a person with self-only coverage is 1/12 of the lesser of the annual deductible under his or her HDHP or \$2,650. For a person with family



coverage, the monthly limitation is 1/12 of the lesser of his or her annual deductible or \$5,250. Additionally, the amount allowable as a deduction for the taxable year may not exceed the sum of the monthly limitations.

Individuals who are at least 55 years old may make additional contributions tax-free, according to a schedule. The allowable additional contribution was \$500 for 2004 and will be increased every year to a maximum of \$1,000 in 2009.

A person other than the account beneficiary may make contributions on behalf of an eligible individual. Amounts an employer contributes to an employee's HSA must be treated as employer-provided coverage for medical expenses under an accident or health plan. Contributions by an employer to an employee's HSA are exempt from employment taxes, although an employer who does not make comparable contributions to comparable participating employees' HSAs must pay an excise tax of 35% of the contributed amount.

Money in an HSA at the end of the year is carried over to the next year and is not included in the monthly or annual limitations.

HSA Distributions

Under the Act, any amount paid or distributed out of an HSA that is used exclusively to pay qualified medical expenses may not be included in gross income. An individual may use the money from his or her HSA to pay expenses that are not qualified medical expenses; however, the amount must be included in his or her gross income. Additionally, the account beneficiary must pay an extra tax equal to 10% of the amount that is distributed to pay expenses other than qualified medical expenses. (The additional 10% tax does not apply to any payment or distribution made after the beneficiary becomes disabled, turns 65, or dies.)

The Act specifies that health insurance premiums are not "qualified medical expenses", subject to certain exceptions.

The Case for HSAs

Proponents of HSAs contend that the accounts allow consumers to decide how their health care dollars are best spent, which ultimately saves money and gives consumers more control over their health care than they have with a health maintenance organization (HMO) or other traditional insurance plan. According to supporters, in addition to promoting cost consciousness, HSAs encourage beneficiaries to adopt healthier lifestyles. Under the conventional system in which employers pay insurance premiums, a patient has the same copay regardless of the source of the service and thus has little incentive to engage in comparison shopping. A patient with an HSA, however, is considered more likely to seek out the best value for his or her money, avoid costly procedures that might not be necessary, and take preventative measures against medical problems.

Health savings account advocates also contend that the accounts contribute to an increase in the number of insured people. The lower premiums that accompany the required HDHP enable families that previously could not afford it to purchase health coverage. According to



a February 2005 report by eHealthInsurance entitled “Health Savings Accounts: The First Year in Review”, in the first year that HSAs were available, 40% of the HSA-eligible plans sold through eHealthInsurance.com were purchased by people with incomes of \$50,000 or less. The most significant increase in the purchasing of HSA-eligible plans occurred among people with incomes of \$15,000 or less. Additionally, the company found that nearly one-third of the HSA purchasers, across all income levels, previously had been uninsured for at least six months.

According to HSA promoters, increased reliance on the accounts will contribute to a better health care environment even for those who do not have them, because the HSA beneficiaries will achieve savings that relieve the stress present in the overburdened system. As mentioned above, HSAs can produce savings when HSA holders adopt healthier habits and comparison shop for services. In addition, claims to be reimbursed by an HSA require less paperwork compared with traditional insurance claims, and help to reduce administrative costs. Thus, even those who find the required HDHP unaffordable or unsuitable will seek treatment in a system with more resources to serve them.

Supporters also note that HSAs are portable, following the beneficiary from job to job and providing a way to pay for necessary care during a period of unemployment. Additionally, some HSA advocates believe that the HSA concept eliminates some of the confusion that many people feel when dealing with a traditional health plan.

HSA Concerns

Some people question whether the benefits of HSAs are as great as proponents claim. Health savings accounts have been criticized as yet another way that employers are shifting the costs of health care to workers.

Some people believe that, because of the high deductible required, the accounts will appeal to healthy people and will not lead to a significant increase in the number of insured. It also has been suggested that the tax benefits gained by contributing to an HSA could be trumped by the higher out-of-pocket costs required under the HDHP.

Another concern is that most account holders are not medical experts. While an HSA beneficiary presumably will make decisions based on the advice of his or her physician, some question whether the average consumer is informed sufficiently to make the right choices in a highly technical field with serious consequences.

State Legislation

Several bills related to HSAs have been introduced in the Michigan Legislature during the 2005-2006 session.

Senate Bill 197, sponsored by Senator Bruce Patterson, would amend the Income Tax Act to allow a taxpayer to claim a State income tax credit equal to his or her contributions to an HSA, for tax years beginning after December 31, 2004. Senate Bill 198, also sponsored by Senator Patterson, would amend the Single Business Tax (SBT) Act to allow a taxpayer to

State Notes
TOPICS OF LEGISLATIVE INTEREST
March/April 2005



claim an SBT credit equal to the contributions the taxpayer made to an HSA on behalf of the taxpayer or the taxpayer's employees, for tax years beginning after December 31, 2005. If the amount of the applicable credit exceeded the taxpayer's tax liability for the tax year, the excess portion of the credit could not be carried forward or refunded. The bills have been referred to the Senate Health Policy Committee.

Representative Fulton Sheen has introduced House Bill 4040, which would amend the Income Tax Act to allow an eligible individual who had established an Archer Medical Savings Account (MSA) or an HSA to deduct, to the extent not deducted in determining adjusted gross income, an amount equal to the difference between the maximum contribution amount allowed to an HSA in the tax year and the maximum deductible limit allowed for the taxpayer, not to exceed the deductible amount under the required HDHP purchased by the taxpayer actually paid in the tax year, for tax years beginning after December 31, 2004. (Archer MSAs were offered under a Federal pilot program as a precursor to HSAs.) Representative Sheen also has introduced House Bill 4041, which provides that Chapter 37 (Small Employer Group Health Coverage) of the Insurance Code would not apply to an HSA. House Bill 4040 has been referred to the House Tax Policy Committee, and House Bill 4041 has been referred to the House Insurance Committee.

State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2005



Great Lakes Water Quality Bond **By Jessica Runnels, Fiscal Analyst**

In November 2002, the voters approved a \$1.0 billion general obligation bond called the Great Lakes Water Quality Bond (GLWQ) to support the existing State Revolving Fund and to create a new Strategic Water Quality Initiatives Fund. Two and half years later, little of this approved funding has been awarded for loans. This article is a look at the circumstances that have delayed full implementation of the bond.

The ballot proposal specified that \$100.0 million of the bond revenue would be directed to the Strategic Water Quality Initiatives Fund (SWQIF) and \$900.0 million of the bond revenue would be for the State Revolving Fund (SRF). Both programs offer loans to local units of government with an interest rate of 1.625% for approved projects. The local governments have 20 years to repay the loans and must demonstrate the financial means to pay the loans in order to qualify. For most local governments, financial means come in the form of a millage levy or increased user fees. Administration of the programs is a joint effort of the Department of Environmental Quality (DEQ) and the Michigan Municipal Bond Authority. The DEQ reviews the project plans and applications for approval and the Bond Authority addresses the financing obligations.

State Revolving Fund

The State Revolving Fund, formally known as the Water Pollution Control Revolving Fund, provides loans to local units of government for construction of sewage treatment works projects, stormwater treatment projects, nonpoint source projects, and refinancing assistance. The program was established in 1989 and demand for the loan funds traditionally has been high. Federal funds, State matching funds, and loan payments are leveraged through revenue bonds to maximize money available for loans. By leveraging the funds with revenue bonds, which the program has been doing since 1992, the State was able to make \$2.1 billion available in SRF loans to local units of government through fiscal year (FY) 2003-04.

When the GLWQ proposal was adopted in 2002, the State had been unable to meet fully the demand for financing from the State Revolving Fund for the previous four years. However, at about the same time the proposal was adopted, the economy began to decline and demand for SRF loans decreased. According to the DEQ, in FY 2000-01, over \$300.0 million in SRF loans was requested and \$210.0 million was awarded. Loan requests dropped to \$175.0 million in FY 2004-05 and all projects received financial support. With the economy in recession, local units of government are experiencing the same budget troubles as the State is facing. They simply do not have the revenue to qualify for bonds or make loan payments. It is easier and less expensive to pay for interim repairs for an ailing wastewater treatment plant and postpone major expansion or construction, than to ask citizens for a fee increase during a difficult economic period with high unemployment.

From the State's perspective, it is fortunate that sufficient funds for State Revolving Fund loans have been available without using the GLWQ bonds because it cannot afford the debt



service on additional general obligation bonds, which is paid from the General Fund. If full debt service payments were due in the current fiscal year on the \$100.0 million in bonds issued, the State would have additional General Fund expenses of \$6.0 million to \$8.0 million. The bond financing has been structured to require only interest payments beginning in FY 2007-08 on the portion of the bonds used. Since the slowing economy has reduced the annual revenue to the General Fund, additional demands on the Fund would be difficult to fulfill. For the past three fiscal years, the State has used non-General Fund sources to pay a portion of the debt service costs on other general obligation bonds, but this means that those funds are not available for programmatic purposes. The availability of other State funds is shrinking as they are used in many other areas of the budget to replace declining General Fund dollars. Statute provides that debt service on GLWQ bonds will be paid with the General Fund. It is unknown if the Legislature would use non-General Fund dollars to pay the debt service on GLWQ bonds, as has occurred recently for other general obligation bonds. That question may be postponed until 2008, which is when the DEQ estimates that the SRF program will need to supplement the existing resources with GLWQ bond revenue in order to meet loan demand.

Strategic Water Quality Initiatives Fund

The Federal law governing the use of Federal and State matching dollars in the State Revolving Fund program limits SRF projects to public facilities and public property. The SWQIF was designed to fill a gap between public and private residential sewer use. Using only State-provided revenue, the SWQIF program awards loans for two types of projects that are not eligible for support from the State Revolving Fund: 1) the construction of on-site upgrade or replacement of septic systems, and 2) the removal of clear groundwater or stormwater from household sewer leads. Many of the SWQIF projects may supplement SRF projects. For example, a project may involve work on both public and private property. The work on public facilities would be covered by the SRF and the work on private property would be covered by the SWQIF. All of the current loans are for footing drain disconnections, which will redirect clear groundwater or stormwater away from a sanitary sewer system and into a storm sewer system or other area where it will not receive unnecessary treatment.

Two and half years after voters approved \$100.0 million in funding for this new program, only \$2.0 million has been awarded in loans. There are two reasons this revolving fund has had a slow start. Since the SWQIF is new funding for a new program, local units of government did not have project planning completed at the time the bond was authorized. The planning process can take from six to 18 months depending on weather conditions. The first two applications for loans were approved in 2004 for communities that had already been in the planning process with the intent to pursue other funding when the SWQIF program was enacted. There are two more SWQIF loans anticipated for 2005 and one future listing of additional segments for a current project. This is a short list of future projects compared with the State Revolving Fund list of 17 future projects, many of which are the continuation of existing multi-year projects. The DEQ is generally aware of upcoming SWQIF projects since applicants are required to work with either the Department's stormwater contact or the local health department during the project planning stage.



Another reason the SWQIF program is just getting rolling is that, similar to the SRF situation, municipalities do not have the money to qualify for and pay the loan obligations due to current economic conditions. A new public works project falls lower on the priority list than many other municipal responsibilities. As local governmental units stabilize their budgets, applications for this program should increase.

The first appropriation of SWQIF loan funds was enacted in FY 2003-04. Approximately \$10.0 million has been appropriated each year, following the original bond issuance schedule recommended in the implementing statute. Appropriations totaling \$20,007,600 have been enacted to provide loans in the two fiscal years since the program was created. The Governor has recommended an appropriation of \$10,010,700 for FY 2005-06, which would bring the total appropriations for SWQIF to \$30,018,300. The appropriations include economic adjustments for the administrative functions to run the program. The statute has been amended to allow up to \$20.0 million in bonds annually for the SWQIF, but annual appropriations have remained near \$10.0 million and loan demand is much lower.

The current SWQIF projects are supported with borrowed funds, and revenue from issued bonds is pledged as security for the loan. The balance of the appropriation was placed in a work project account, which holds the funding for four more years and allows additional expenditures over that period. If the work project funds are not spent after four years, then the money will lapse to the SWQIF and be available again for future loan applicants, subject to appropriation.

Conclusion

The economy and local units of government were not prepared for the Great Lakes Water Quality bond when it was adopted in November 2002. Demand for the loans and projects existed, but economic pressures forced municipalities to delay proposals. In addition, the SWQIF was a new program and municipalities need project planning time. As the economy recovers and the State and local government budgets are stabilized, the full implementation of the bond should be realized.

State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2005



Membership and Contribution Rate Changes for Michigan's Two Largest Retirement Systems -- A 10-Year History

By Joe Carrasco, Jr., Fiscal Analyst

The State of Michigan currently maintains and operates four pension plans on behalf of Michigan workers. These State-administered plans include: the Michigan State Employees Retirement System (MSERS), the Michigan Public School Employees Retirement System (MPERS), the Michigan State Police Retirement System, and the Michigan Judges Retirement System. This update concentrates on Michigan's two largest systems, the MSERS and the MPERS.

The Michigan State Employees Retirement System

The MSERS is administered by the State of Michigan and was created under Public Act 240 of 1943. The system provides retirement benefits to virtually all of Michigan's government employees. The plan also provides survivor and nonduty and duty disability benefits. Michigan judges, legislators, and State police officers are covered under separate retirement systems.

The MSERS is a defined benefit (DB) plan, which means that members receive a guaranteed monthly benefit upon retirement based on average final salary and years of service. Generally, members may retire with full benefits at age 55 with 30 or more years of service or at age 60 with 10 or more years of service. Their pension amount is determined by using the 36-consecutive-month period that produce the highest final average compensation (FAC).

As of March 31, 1997, the MSERS is a closed system, meaning that newly hired State employees cannot become members of the MSERS. Instead, newly hired State employees must become members of the new (as of April 1, 1997) defined contribution (DC) plan. For DC members, the State contributes a minimum of 4% of salary into an employee's private 401(k) account. The account is managed by the employee through a third-party administrator. Defined contribution members may contribute additionally to their plan with the first 3% matched dollar-for-dollar by the State. Upon retirement, DC plan members can choose to take their funds via a lump sum payment or in annuities. Defined benefit plan members may not contribute to their DB retirement plan, although, they may contribute to separate 401(k) or 457 individual accounts.

Due to new hires' having to become members of the DC retirement plan, total membership in MSERS has been on a steady decline over the past decade. As shown in Table 1 below, total membership in the plan fell from 94,900 members at the end of fiscal year (FY) 1995-96 to a low of 80,395 at the end of FY 2003-04, the last year for which complete figures are available. Due to budget cuts over the last three fiscal years, active membership has fallen by 8,288 employees from FY 2001-02 to FY 2003-04.

There are two additional causes for the decline in membership in the MSERS. The first is the closing off of the system and the creation of the new DC retirement plan for new hires. Currently, there are about 19,000 members in the DC plan who have been hired since the implementation of the new plan. Additionally, nearly 1,500 members who were vested in the DB plan, along with nearly 2,000 nonvested members, switched over to the new DC plan in 1997.

State Notes
TOPICS OF LEGISLATIVE INTEREST
 March/April 2005



Table 1
Michigan State Employees Retirement System
Member, Wage, and Contribution Data – FY 1995-96 to FY 2004-05
(Thousands of Dollars)

Defined Benefit	Fiscal Year									
	FY 1995-96	FY 1996-97	FY 1997-98	FY 1998-99	FY 1999-2000	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05
Active Members	63,807	55,434	49,717	49,612	47,778	45,852	43,064	36,536	34,776	N/A
Retired Members	31,093	36,123	36,185	36,346	36,705	37,111	39,666	45,491	45,619	N/A
Total Members	94,900	91,557	85,902	85,958	84,483	82,963	82,730	82,027	80,395	N/A
Pension Rate	10.28%	10.62%	5.37%	5.10%	5.04%	4.74%	3.68%	4.02%	7.87%	13.12%
Health Rate	5.69%	4.82%	5.01%	5.50%	6.00%	8.75%	9.00%	12.50%	13.05%	11.40%
Total Rate	15.97%	15.44%	10.38%	10.60%	11.04%	13.49%	12.68%	16.52%	20.92%	24.52%
Wages (DB)	\$2,515,420	\$2,273,203	\$2,107,996	\$2,213,851	\$2,253,818	\$2,230,562	\$2,133,477	\$1,859,555	\$1,889,410	\$1,946,092 ^a
Pension Contribution	\$258,585	\$241,414	\$113,199	\$112,906	\$113,592	\$105,729	\$78,512	\$74,754	\$148,697	\$255,327
Health Contribution	\$143,127	\$109,568	\$105,611	\$121,762	\$135,229	\$195,174	\$192,013	\$232,444	\$246,568	\$221,854
Total Contribution	\$401,712	\$350,982	\$218,810	\$234,668	\$248,821	\$300,903	\$270,525	\$307,198	\$395,265	\$477,181

^{a)} Assumes growth of 3% from prior year

Source: Michigan Office of Retirement Services



The second reason for the decline is two early retirement provisions that were adopted in 1997 and 2002. Michigan has offered two early retirement windows for State employees over the last decade. The first, in 1997, saw nearly 5,000 members take advantage of that early retirement opportunity. The second early retirement option occurred in 2002. That window saw just over 8,000 State employees retire early. Both early retirement provisions allowed members to retire with full benefits sooner than they otherwise would have been eligible to retire and with enhanced benefits. Current law allows DB plan members to receive 1.5% of their FAC times years of service as their pension. Both of the early retirement provisions allowed eligible members to retire using a 1.75% multiplier, compared with the normal 1.5% multiplier. These early retirements account for just over 13,000 of the 29,031-member decline in the active workforce in the MSERS over the 10-year period.

Table 1 also compares the changes in the contribution rates over the last 10 years. The contribution rate is the percentage of payroll that the State pays into the system each year to pay for the current and future retirement benefits for its members. The total contribution rate consists of two key pieces: the pension rate and the health insurance rate. The pension rate is the amount needed to pay for retirement benefits and is composed of two parts, the normal cost portion of the rate (the amount needed to pay normal pensions) and the unfunded accrued liabilities (UAL) portion of the rate. Unfunded accrued liabilities are the portion of pension payments (current or future) that are unaccounted for in the system. The largest contributors to the UAL portion of the pension rate are early retirements and lower-than-anticipated interest earnings on the pension system's assets.

As demonstrated in Table 1, the pension rate has fluctuated dramatically since FY 1995-96. The pension rate was nearly cut in half in FY 1997-98 due to a one-day valuation of the system's assets in FY 1996-97. To take advantage of the stock market gains of the mid 1990s, the MSERS performed a one-day valuation of its assets on September 30, 1997. This allowed the system's assets to be valued at the higher market rate (versus the five-year smoothed market rate) for that one day, which enabled the system to pay off all of its existing UAL, resulting in a lower pension rate. As seen, the pension rate has gradually grown over time due to the early retirement provisions of 1997 and 2002. The pension portion of the total rate has increased significantly for FY 2004-05, from 7.87% in FY 2003-04 to 13.12% in FY 2004-05. The reason for this large increase is the dropping off of the final "good market year" of 2000 and fully having to realize the "bad market years" of 2001 and 2002 that continue currently.

The second portion that makes up the total contribution rate is the health insurance rate. This is the percentage of payroll that is needed to pay the health insurance benefits for currently retired members. Health benefits for retired members are paid on a cash (pay-as-you-go) basis. This means that health benefits are paid as they are accrued. The health insurance rate then is the percentage of the active member payroll that is needed to pay those cash health benefits. As the number of retirees and the costs of health care increase, the percentage of payroll necessary to pay for those benefits also increases, and is the primary reason for the continuous rise in the health insurance rate from year to year as demonstrated in Table 1. Because the number of retirees has grown more rapidly than actuarially calculated as a result of the two early retirement provisions, the health insurance rate has doubled over the last 10 years from 5.69% in FY 1995-96 to the current 11.40% rate in FY 2004-05.



The Michigan Public School Employees Retirement System

The MPSERS is administered by the State of Michigan and was originally created under Public Act 136 of 1945. Since the Act was recodified in 1980, the system now operates under the provisions of Public Act 300 of 1980, as amended. The MPSERS provides retirement benefits to employees of the State's K-12 public school districts, public school academies, district libraries, all tax-supported community colleges, and seven of Michigan's 15 public universities. These universities include: Central Michigan, Eastern Michigan, Northern Michigan, Western Michigan, Ferris State, Lake Superior State, and Michigan Tech. Like the State Employees Retirement System, the MPSERS also provides survivor and non-duty and duty disability benefits.

The MPSERS also is a defined benefit plan. The biggest difference between the MPSERS plan and the MSERS plan, however, is that the MPSERS currently is still an open plan, meaning that there is no provision for members to be part of any defined contribution plan. All members, including new hires, are DB members. However, there are two types of DB members in the MPSERS plan.

Before January 1, 1987, all members were part of what is known as the Basic Plan. These members may retire at age 55 with 30 or more years of service or at age 60 with 10 years of service. Their pension amount is determined by using the 60 consecutive months that produce the highest final average compensation and there is no employee contribution required for members of the Basic Plan.

On January 1, 1987, the Member Investment Plan (MIP) was enacted. Then-current members were given an opportunity to become members of the new MIP or remain in the Basic Plan. Additionally, all new hires after January 1, 1990, are mandated to become members of the MIP. These members receive enhanced benefits that include: eligibility to retire at any age provided they have 30 or more years of service, eligibility to retire at age 60 with 10 or more years of service, and eligibility to retire at age 60 with five years of service provided that the member works through his or her 60th birthday and has credited service in each of the five immediately preceding years. The biggest benefit to MIP members is that their FAC is determined using a 36-consecutive-month period versus a 60-month period for Basic Plan members. This results in a higher FAC for MIP members and thus an enhanced benefit. However, MIP members must contribute to the plan. Those who became MIP members before January 1, 1990, contribute a fixed 3.9% of salary to the MIP, while those who became MIP members on or after January 1, 1990, contribute at the following fixed rates: 3% of the first \$5,000 of salary; 3.6% of salary between \$5,001 and \$15,000; 4.3% of all salary above \$15,000.

Unlike the State employee plan, total membership in the MPSERS has continually grown over the last eight years among both active and retired members, mainly due to the fact that the MPSERS does not offer a DC plan component. As shown in Table 2, total membership grew from 402,561 members in FY 1995-96 to 466,851 in FY 2003-04 (again, the last year complete figures are available). The growth in total membership of 64,290 over the eight-year period is composed of 26,167 in active members and 38,123 retirees. Due to the budget constraints over the last three fiscal years, the number of active members has grown at a slower pace than the number of retirees. In fact, the number of active members fell in FY 2003-04 for the first time during the period studied, dropping by 5,675 while the number of retired members has continued to grow.

State Notes
TOPICS OF LEGISLATIVE INTEREST
 March/April 2005



Table 2

Michigan Public School Employees Retirement System Member, Wage, and Contribution Data - FY 1995-96 to FY 2004-05 (Thousands of Dollars)										
Defined Benefit	Fiscal Year									
	FY 1995-96	FY 1996-97	FY 1997-98	FY 1998-99	FY 1999-2000	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05
Active Members	295,096	295,691	302,016	309,324	312,699	318,538	326,350	326,938	321,263	N/A
Retired Members	107,465	111,842	116,620	120,913	126,115	130,790	135,277	139,814	145,588	N/A
Total Members	402,561	407,533	418,636	430,237	438,814	449,328	461,627	466,752	466,851	N/A
Pension Rate	10.88%	11.22%	7.14%	6.73%	7.06%	6.61%	6.12%	6.94%	6.94%	8.32%
Health Rate	3.68%	3.95%	3.98%	4.04%	4.60%	5.55%	6.05%	6.05%	6.05%	6.55%
Total Rate	14.56%	15.17%	11.12%	10.77%	11.66%	12.16%	12.17%	12.99%	12.99%	14.87%
Wages (DB)	\$7,807,029	\$8,027,450	\$8,265,463	\$8,643,718	\$8,984,737	\$9,264,183	\$9,707,281	\$10,032,465	\$10,150,428	\$10,454,941 ^a
Pension Contribution	\$849,405	\$900,680	\$590,154	\$581,722	\$634,322	\$612,362	\$594,086	\$696,253	\$704,440	\$869,851
Health Contribution	\$287,299	\$317,084	\$328,965	\$349,206	\$413,298	\$514,162	\$587,291	\$606,964	\$614,101	\$684,799
Total Contribution	\$1,136,704	\$1,217,764	\$919,119	\$930,928	\$1,047,620	\$1,126,524	\$1,181,377	\$1,303,217	\$1,318,541	\$1,554,650
^{a)} Assumes growth of 3% from prior year.										

Source: Michigan Office of Retirement Services



The contribution rate for the MPSERS is broken down exactly as it is for the MSERS; that is, the total contribution rate consists of the pension rate and the health insurance rate. As shown in Table 2, the pension rate also declined sharply in FY 1997-98 due to the one-day valuation on September 30, 1997, as described earlier. The pension rate went from 11.22% in FY 1996-97 to 7.14% in FY 1997-98. Due to the one-day valuation, the MPSERS also was able to pay off its unfunded liabilities, which resulted in the lowering of the pension rate for the system. Unlike the State employee system, the 8.32% pension rate for the MPSERS in FY 2004-05 is still well below the pension rate of 11.22% in FY 1996-97 before the one-day valuation. As with the MSERS, the pension rate for the MPSERS rose more than normal from FY 2003-04 to FY 2004-05, again due to the last good year of stock market gains dropping off of the five-year smoothing actuarial assumption. The primary reason that the rate increases remain lower than those of the MSERS is that the MPSERS is still an open system and there have been no State-wide early retirement provisions adopted.

The health insurance portion of the rate for the MPSERS has increased only slightly since FY 1995-96. The health insurance rate has risen only by 2.87 percentage points over the 10-year period. As Table 2 shows, the rate has risen only a total of one percentage point (from 5.55% to 6.55%) from FY 2000-01 to the current FY 2004-05. The primary factor that has kept the health insurance rate increase so low is that the MPSERS has been using excess funds from the Stabilization Subaccount to help pay for a portion of the health insurance benefits for retired members.

The Stabilization Subaccount was created in 1997 for the deposit of any overfunding amounts. The MPSERS was able to use \$140 million from this fund in both FY 2003-04 and FY 2004-05 to help pay for health benefits. The use of these funds from the Stabilization Subaccount allowed the health insurance rate that was applied to the active member salaries to remain at 6.05% for FY 2003-04. The rate increased by only one-half of one percentage point to 6.55% for FY 2004-05 as a result of the use of funds from the Stabilization Subaccount. The remaining \$50.0 million in the Stabilization Subaccount will be used in FY 2005-06 again to defray the health insurance costs, thus lowering the amount of increase in the health insurance rate from what it otherwise would have to be.

Conclusion

Although there always will be fluctuations in both the membership and the contribution rates among the State's two largest retirement systems, it is safe to say that both systems remain sound and properly funded. According to the FY 2002-03 Annual Reports, the State Employees Retirement System is funded at 98.0% while the Public School Employees Retirement System is funded at 92.0%. This indicates that both systems are doing well. As the MSERS gets closer to retiring its final DB employees (in about 50 years), it will rely more and more on the assets in the system rather than on the contributions of the active members, since the number of active members will continue to decline. As for the MPSERS system, if the growth in the number of retirees continues to outpace the number of active employees, more stress will be placed upon the system's assets and will likely result in higher contribution rates down the road. Another problem facing the MPSERS is that as health care costs continue to rise, since all of the excess funds in the Stabilization Subaccount will have been depleted by the end of FY 2005-06, the health insurance rate also will rise. Due to the use of the funds from the Stabilization Subaccount, the health insurance rate will rise at some point by an amount necessary to make up for being kept artificially low for the three years that those excess funds were used.